LPL RESEARCH
WEEKLY ECONOMIC COMMENTARY

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FOMC FAQS: ALIGNMENT AT LAST?

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KEY TAKEAWAYS

The Fed holds its eighth and final FOMC meeting of 2016 this Tuesday and Wednesday, December 13–14, 2016.

The fed funds futures market is fully pricing in a 25 basis point (0.25%) rate hike at this week's meeting.

Fed Chair Yellen's fourth and final post-FOMC meeting press conference of 2016 provides an opportunity for the Fed to justify their actions or intentions, as well as add color to its views of the economy, inflation, and financial market volatility in the months ahead.

As the eighth and final Federal Open Market Committee (FOMC) meeting of 2016 approaches later this week, for the first time in a long time the market and the Federal Reserve (Fed) are more or less aligned when it comes to monetary policy. However, it may be fiscal policy, not monetary policy that is a key source of disagreement between the Fed and the market in 2017. In addition, the FOMC itself seems more divided as 2016 ends and 2017 begins.

WHAT IS THE SCHEDULE OF EVENTS FOR THE FED THIS WEEK?

The FOMC meetings on Tuesday and Wednesday (December 13–14, 2016), will be followed by an FOMC statement at 2:00 p.m. ET on Wednesday, along with the FOMC's latest economic forecasts for gross domestic product (GDP), the unemployment rate, inflation, and fed funds projections (aka the "dot plots") for year-end 2017, 2018, and 2019, as well as the "long run." At 2:30 p.m. ET on Wednesday, Fed Chair Janet Yellen will hold her fourth and final post-FOMC press conference of 2016.

HAS THE MARKET PRICED IN A RATE HIKE AT THIS WEEK'S MEETING?

Yes, the fed funds futures market is fully pricing in a 25 basis point (0.25%) rate hike at this week's meeting. In fact, for the first time in several years, the Fed and the market are broadly aligned, not only for this week's meeting but for the path of rates over the next 12 months (see below).

Another good proxy for what the market is pricing in is the yield on the 2-year Treasury note, the Treasury note being most sensitive to the Fed's actions. The 2-year note yield has moved from 0.55% in late July 2016—in the aftermath of the late June Brexit vote and a weak June 2016 employment report (released in early July 2016)—to just under 0.80% prior to the U.S. presidential election in early November 2016, and today, stands at 1.15%, the highest since early 2010 [Figure 1].

HOW LARGE IS THE DISCONNECT BETWEEN THE FED AND THE MARKET ON RATES?

The FOMC's latest forecast (September 2016) puts the fed funds rate at 0.625% by the end of 2016. The Fed will provide a new set of dot plots this week. As noted above, the market (according to fed funds futures) also puts the fed funds rate at around 0.625% by the end of 2016 [Figure 2], fully pricing in a 25 basis point (0.25%) rate hike this week. The latest dot plots (released in September 2016) had put the fed funds rate at 1.125% at the end of 2017, right in line with the fed funds futures market. The September 2016 dot plots put the fed funds rate at 1.875% by the end of 2018, while the market says it will be 0.25% lower than that at around 1.625%.

This "agreement" between the Fed and the market is relatively new. In early 2016, just after the Fed's first rate hike of the cycle in December 2015, the FOMC's dot plots expected eight 0.25% rate hikes in 2016 and 2017. The market expected just two 0.25% hikes. That large disconnect between the market and the Fed was one of the root causes of the imbalances that plagued global financial markets in late 2015 and the first few months of 2016. Cleary, no such disagreement is evident today.

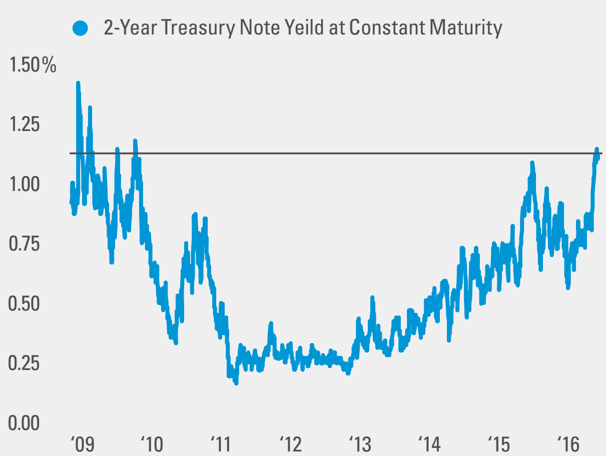
WILL FISCAL POLICY GET A MENTION THIS WEEK?

Fiscal policy is not likely to get mentioned in the FOMC statement or in Fed Chair Yellen's prepared remarks, but the press is likely to ask Yellen about the interaction of fiscal and monetary policy during her press conference. In addition the minutes of this week's meeting (due out in early January 2017) will almost certainly contain some mention of the many fiscal policy proposals now floating around Washington. Yellen is likely to note that without specifics on the mix and timing of policies, the Fed will adopt a "wait and see" attitude, and that monetary policy will adjust as needed based on the details of any fiscal policy stimulus.

WHAT ABOUT THE HAWK-DOVE BALANCE ON THE FOMC?

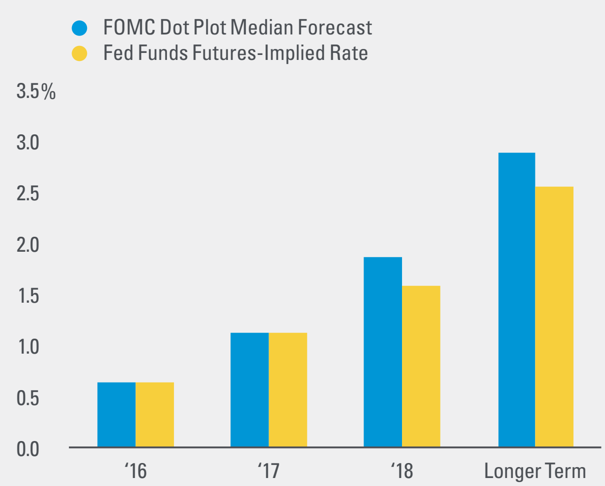
The annual rotation of FOMC voters doesn't occur until the first FOMC meeting of 2017, slated for late January 2017/early February, so the voters at this week's meeting will be the same as they have throughout 2016. President-elect Trump will also have the ability to fill two vacancies on the Federal Reserve Board of Governors, who also serve on, and are permanent voters on, the FOMC. We'll update the hawk-dove balance on the FOMC when we preview the January/February 2017 FOMC meeting in late January 2017. Ms. Yellen's term as Chair of the Fed ends in February 2018, and she has made it clear publicly that she intends to remain in her job until then. This may be a persistent line of questioning by the press in Yellen's press conference.

1 THE MARKET HAS FULLY PRICED IN A 0.25% RATE HIKE THIS WEEK LEAVING THE 2-YEAR NOTE AT HIGHEST LEVEL SINCE 2010



Source: LPL Research, Federal Reserve, Haver Analytics 12/12/16
Performance is historical and no guarantee of future results.

2 THE MARKET AND THE FED ARE ALIGNED ON PATH OF RATES FOR 2017



Source: LPL Research, Federal Reserve, Haver Analytics 12/12/16
Rates may not develop as predicted. Long run is defined as five years.

WILL THE FOMC RETAIN ITS PROMISE TO ADJUST MONETARY POLICY GRADUALLY?

Since the December 2015 FOMC meeting, the FOMC statement has included language indicating that it intends to make only gradual adjustments to the Fed's interest rate policy. We expect that the FOMC will retain this language, and that the FOMC will continue to make future rate hikes "data dependent"; i.e., that as long as the incoming data on the economy, labor market, and inflation track to the Fed's forecasts, it will continue to raise rates. Our view remains that the economy, labor market, and inflation will track to—or perhaps just above—the Fed's forecasts in 2017, warranting two 25 basis point hikes next year. ■

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